FILE COPY

FILED
FEB 14 1
CHARLES

Nos. 323 and 324

In the Supreme Court of the United States

OCTOBER TERM, 1929

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

KANSAS CITY STRUCTURAL STEEL COMPANY

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

KANSAS CITY STRUCTURAL STEEL COMPANY

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE PETITIONER

INDEX

	Page
Opinions below	1
Jurisdiction	2
Questions presented	2
Statute and regulations involved	2
Statement of facts	5
Specification of errors	9
Summary of argument	10
Argument:	
I. Inventories of the taxpayer's stock of unfabricated steel were necessary to a proper determination of its income	11
II. The "base stock" method of inventory valuation employed by the taxpayer is not in accord with the best accounting practice and does not truly reflect income	19
Conclusion	25
Appendix	27

CITATIONS

Cases:	
American Can Co. v. *United States*, 31 F. (2d) 730	24
American Can Co. v. *Bowers*, 35 F. (2d) 832	24, 25
Avery v. *Commissioner of Internal Revenue*, 22 F. (2d) 6	25
Bates & Guild Co. v. *Payne*, 194 U. S. 106	18
Bellefield v. *Heiner*, 25 F. (2d) 560	16
Bishoff v. *Commissioner*, 27 F. (2d) 91	25
Brown v. *Commissioner*, 22 F. (2d) 797	25
Chicago Frog & Switch Co. v. *United States* (unreported), decided by Court of Claims June 3, 1929	17, 23–24
Maryland Casualty Co. v. *United States*, 251 U. S. 342	16
Reinecke v. *Spalding*, 280 U. S. 227	25
United States v. *Grimaud*, 220 U. S. 506	16
United States v. *Kemp*, 12 F. (2d) 7, certiorari denied, 273 U. S. 703	17
Wickwire v. *Reinecke*, 275 U. S. 101	25
Williamsport Co. v. *United States*, 277 U. S. 551	18
Statutes:	
Revenue act of 1918, c. 18, 40 Stat. 1057, 1060, 1065, 1077—	
Sec. 203	3, 18
Sec. 213(a)	2, 3
Sec. 232	2

Regulations:
Treasury Regulations 45 (1920 Ed., as amended by T. D. 3296)— Page
Article 1581 3
Article 1582 3-5
Treasury Regulations 62, art. 1582 23
Treasury Regulations 65, art. 1612 23
Treasury Regulations 69, art. 1612 23
Treasury Regulations 74, art. 102 23
Miscellaneous:
Foulke, The Federal Income Tax, sec. 642 17
Montgomery, Income Tax Procedure (1926 Ed.), Vol. I, pp. 698, 712 ..... 17, 23
Tax Board Ruling 65, 1 C. B. 51 ..... 21-23, 27-35

In the Supreme Court of the United States

OCTOBER TERM, 1929

No. 323

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, petitioner

v.

KANSAS CITY STRUCTURAL STEEL COMPANY

No. 324

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE, petitioner

v.

KANSAS CITY STRUCTURAL STEEL COMPANY

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 20–26) is reported in 11 B. T. A. 877. That of the United States Circuit Court of Appeals for the Eighth Circuit (R. 31–42) is reported in 33 F. (2d) 53.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on May 14, 1929. (R. 43, 45.) The petition for writs of certiorari was granted October 21, 1929. (R. 47.) The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Did the Commissioner of Internal Revenue, in determining the income of the taxpayer corporation for the years in question, properly require the taxpayer to inventory a supply of unfabricated steel designated by it as an "emergency supply"?

2. Was the Commissioner correct in rejecting the "base stock" system of inventory valuation used by the taxpayer with respect to this so-called "emergency supply," and in substituting therefor a "market price" valuation?

STATUTE AND REGULATIONS APPLICABLE

The pertinent parts of the Revenue Act of 1918, c. 18, 40 Stat. 1057, 1060, 1065, 1077, are as follows:

> SEC. 232. * * * the term "net income" means the gross income * * * less the deductions allowed * * *.
>
> SEC. 213. * * * the term "gross income"—
>
> (a) Includes gains, profits, and income derived from * * * trades, businesses, commerce, or sales, or dealings in property,

whether real or personal, growing out of the ownership or use of or interest in such property; also from * * * the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

SEC. 203. That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

The pertinent provisions of Treasury Department Regulations 45 (1920 Edition, as amended by Treasury Decision 3296), promulgated under the Revenue Act of 1918, are as follows:

ART. 1581. *Need of inventories.*—In order to reflect the net income correctly, inventories at the beginning and end of each year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include raw materials and supplies on hand that have been acquired for sale, consumption, or use in productive processes, together with all finished or partly finished goods * * *.

ART. 1582. *Valuation of inventories.*—The act provides two tests to which each inven-

tory must conform: (1) It must conform as nearly as may be to the best accounting practice in the trade or business, and (2) it must clearly reflect the income. * * * In order to clearly reflect income the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation, so long as the method or basis used is substantially in accord with the regulations. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

The basis of valuation most commonly used by business concerns and which meets the requirements of the revenue act is (*a*) cost or (*b*) cost or market, whichever is lower. * * *

* * * Goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices will be deemed to be either (*a*) the goods most recently purchased or produced, and the cost thereof will be the actual cost of the goods purchased or produced during the period in which the quantity of goods in the inventory has been acquired, or (*b*) where the taxpayer maintains book inventories in accordance with a sound accounting system * * * the net value as shown by

such inventory accounts will be deemed to be the cost of the goods on hand. * * * * * * The inventories of taxpayers on whatever basis taken will be subject to investigation by the commissioner, and the taxpayer must satisfy the commissioner of the correctness of the prices adopted.

The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with these regulations, viz:

* * * * *

(*d*) Using a constant price or nominal value for a so-called normal quantity of materials or goods in stock.

(NOTE.—The above provision relative to the valuing of inventories at a constant price is in effect a restatement of a Treasury ruling promulgated in *September,* 1919, as Advisory Tax Board Ruling No. 65, appendix, p. 27.)

STATEMENT

These cases involve income and profits taxes for the years 1918 and 1920. (R. 20.) The facts in both cases so far as they affect any question here are identical except for the differences in the years and the amounts of tax involved. (R. 44.)

The taxpayer is a Missouri corporation which was engaged, during the years in question, in the business of fabricating and erecting structural steel plates for buildings, bridges, tanks, etc. It used large quantities of steel bars, tank plates, and

structural forms which it procured, for the most part, directly from steel mills in accordance with the requirements of the particular job at hand. (R. 18, 20–21.)

In order to insure the prompt and orderly execution of its contracts it was the practice of the taxpayer to maintain a considerable stock of unfabricated steel at its plant. (R. 20–21.)

The amount of such stock recorded as being on hand at the end of each year was, roughly speaking, equal to from one-fourth to one-fifth of the steel fabricated by the taxpayer during the entire year. (See Tables, R. 21–22.) However, the exact quantity on hand at any one time varied greatly because the stock was being consumed and replenished continually in the course of production. In 1912 the stock ran as low as 1,500 tons and in 1920 it at one time exceeded 11,000 tons. See chart immediately following R. 18 marked "Exhibit A," which was made a part of the facts stipulated. (R. 16–18, 20.)

When steel was used from the taxpayer's stock it was promptly replaced with material of a like kind in a like quantity. (R. 21.) It does not appear, however, that any account was kept of the particular purchases composing the stock, or that any portion of the stock was identifiable either as to cost or date of acquisition. (R. 25.)

In 1916 the price of structural steel, such as that composing the taxpayer's stock, was $1.70 per cwt., f. o. b. Pittsburgh. The price then advanced

rapidly until July, 1917, when it reached $4.50 per cwt. for structural shapes and $9.45 per cwt. for tank plates. (R. 19, 21.) In September, 1917, the Government fixed the price of structural shapes at $3 per cwt. and that of tank plates at $3.25 per cwt., f. o. b. Pittsburgh. At the close of 1918 Government control was released and the price then gradually declined until 1921, when it reached $1.50 per cwt. for both structural forms and tank plates. (R. 21.) During the years here in question the prices were as follows (R. 19):

	1918	1920
Structural shapes	$3.00	$3.25-$2.45
Tank plates	3.25	3.75-2.65

The taxpayer, in determining the amount of its taxable income for the years 1918 and 1920, used inventories to compute the cost of the steel which it had consumed during each of those years. (R. 17, 21.) The method followed was that which was used by the taxpayer from 1916 to 1921, whereby at the close of each year it valued its inventory by considering 5,554 tons of unfabricated steel (an arbitrary amount equal to its 1916 closing inventory) as constituting a fixed stock or minimum inventory and this amount was priced at $1.70 per cwt. f. o. b. Pittsburgh (an arbitrary price equal to the cost of steel at the close of 1916). The balance of its stock, in excess of 5,554 tons, it valued at cost or market, whichever was lower. (R. 21.) The tonnage in stock during most of the years

1918 and 1919 was actually considerably less than 5,554 tons; during most of 1920 it was considerably above that amount. (See chart following R. 18.)

This method of valuing its inventory was employed by the taxpayer until December 31, 1921, when the price of steel had declined to $1.50 per cwt. The method was then abandoned and the entire inventory was valued by the taxpayer at cost or market, whichever was lower. (R. 21, 22.)

The Commissioner of Internal Revenue, in auditing the tax returns of the taxpayer for the years in question, accepted the tonnages shown in its inventories, but refused to accept the inventory valuations of the 5,554 tons as computed by the taxpayer's method. Since the steel composing the stock had been so intermingled that its cost could not be determined by identifying individual items with specific invoices, the Commissioner, in accordance with Treasury Regulations, computed its cost on the presumption that the steel on hand was that which had been most recently received. (R. 17, 22.) He valued at "market" the entire tonnage shown in the inventories, and thus increased both the opening and closing inventory valuations, as follows (R. 21):

Date	Per company	Per commissioner	Increase
Dec. 31, 1917	$271,827.87	$402,688.55	$130,860.68
Dec. 31, 1918	446,984.06	612,833.52	165,849.46
Dec. 31, 1919	449,976.69	562,992.28	113,015.59
Dec. 31, 1920	319,189.26	436,302.87	117,113.61

Such action of the Commissioner resulted in tax deficiencies being determined for the years 1918 and 1920 in the amounts of $7,656.74 and $15,953.36, respectively.

The taxpayer appealed from such determinations to the Board of Tax Appeals, but the Board approved the determinations of the Commissioner. (R. 25.) The taxpayer then filed a petition for review in each of its cases, seeking a review of the Board's decision by the United States Circuit Court of Appeals for the Eighth Circuit; and it was stipulated that the judgment entered in the case involving the year 1918 should control the case involving the year 1920. The Circuit Court of Appeals, by a divided bench, reversed the decision of the Board of Tax Appeals. (R. 31–42, 43, 45–46.) Writs of certiorari to the Circuit Court of Appeals have been issued by this Court. (R. 47.)

SPECIFICATION OF ERRORS

The Circuit Court of Appeals erred—

1. In holding that inventories of the taxpayer's reserve stock of steel should not have been used in computing its income for the years in question.

2. In overruling the determination made by the Commissioner, pursuant to discretion vested in him by statute and under regulations of the Treasury Department, that inventories of the reserve stock were necessary properly to determine taxable income.

3. In holding that no taxable gain was realized by the taxpayer upon 5,554 tons of steel, the amount which taxpayer treated as its reserve stock.

SUMMARY OF ARGUMENT

By the use of low-cost steel in productive processes during years of a rising steel market, taxpayer derived gains which its method of inventorying did not reflect. The Commissioner of Internal Revenue was justified in disapproving taxpayer's method of valuing at a constant cost an arbitrary amount of its reserve stock, for there was no actual segregation of such an amount, but all steel held in reserve was commingled in an indistinguishable mass from which continual withdrawals were made for productive purposes. The reserve stock drawn upon for production frequently contained steel of varying cost which could not be identified with specific invoices, and hence the cost of the steel consumed could be determined only by resort to inventories. The facts here do not warrant a conclusion that the business of the taxpayer constituted any exception to the statutory requirement for the use of inventories. In these cases the Commissioner of Internal Revenue, exercising discretion vested in him by statute, held that inventories were necessary to a proper determination of taxpayer's income. That determination should not be disturbed.

The taxpayer itself used inventories in computing its income but it valued those inventories by a "base stock" or "constant price" method which

the Commissioner refused to approve. The "base stock" method does not truly reflect income; it is not in accord with the best accounting practice; and it is expressly disapproved in regulations of the Treasury Department which have been consistently applied for more than ten years in the collection of the revenue. The courts also have refused to sanction such method of valuation.

The taxpayer in this case did not consistently use the "base stock" method but applied it only in the years of rising prices. It has failed to prove that such method was in accord with the best accounting practice in its trade or business. The Commissioner, on the other hand, has determined that the taxpayer's method of valuation was not in accord with the best accounting practice in the trade or business, and has found that the method did not truly reflect income. His determinations are *prima facie* correct, and, in the absence of any competent evidence to the contrary, they should be approved.

ARGUMENT

I

INVENTORIES OF THE TAXPAYER'S STOCK OF UNFABRICATED STEEL WERE NECESSARY TO A PROPER DETERMINATION OF ITS INCOME

The decision of the Circuit Court of Appeals in the instant cases holds in substance that the action of the Commissioner of Internal Revenue in requiring the taxpayer to include a stand-by or

"emergency" stock of unfabricated steel in its general inventory had the effect of distorting rather than reflecting income. The majority opinion below is based upon the conclusion that the taxpayer's business was not one requiring the use of inventories in the determination of income, and that its stand-by stock was equivalent to fixed equipment such as "cranes and derricks" (R. 38–39); was not "liquidated" and produced no income. It was, therefore, held that it was proper for the taxpayer to carry the stock at a constant valuation over the years here in question.

The Government here contends that by the use in productive process of low cost steel from its general reserve stock during years of a rising steel market the taxpayer made taxable gains which were disclosed only by the inventory method required by the Commissioner. It is also contended that the constant price valuation followed by the taxpayer was in reality nothing more than the "minimum" or "base stock" method of inventory, which is neither sanctioned by good accounting practice nor by the regulations of the Department.

It is submitted that from the facts found the court below erred in regarding the so-called "emergency stock" arbitrarily set by the taxpayer at 5,554 tons as the equivalent of fixed equipment and as "unliquidated" through the years in question. During the period that the taxpayer carried 5,554 tons at a constant inventory valuation there was never any actual segregation of such an amount,

but all steel held in reserve was commingled in an indistinguishable mass from which continual withdrawals were made for productive purposes. (R. 20–22, 25.) Such withdrawals frequently reduced the total stock on hand below 5,554 tons and during the greater part of the years 1918 and 1919 the stock remained below that figure. In fact, in 1919 it had receded to between 2,000 and 3,000 tons. (See Exhibit A inserted after R. 18.) Also, in 1917 and 1921 there were not 5,554 tons on hand when the closing inventories were reported. (R. 21.)

While it is indicated in the opinion of the Board of Tax Appeals that "some undeterminable part of the steel on hand in 1916 remained during the taxable years" (R. 24), the taxpayer had the burden of showing the cost of goods on hand, and in the absence of identification of a definite amount the stock on hand must be considered to be that most recently purchased. See Article 1582, Regulations 45, *supra*. It is clear that the greater part of the original 5,554 tons did not remain on hand throughout the period. The majority opinion below was, therefore, not correct in treating the reserve stock as remaining "intact" (R. 38) or in comparing it with fixed equipment such as "cranes and derricks." (R. 39.)

Considering all the facts, it seems clearly to be "of the substance" that the steel used in production from the reserve stock was converted and sold for a price higher than its cost with the resultant

taxable gain. Such profit is no more a "paper one" than would be the gain derived from the sale of a derrick for a price above that of its cost, even if the amount received from the sale should immediately be reinvested in another derrick.

While it is true, as the majority opinion below states (R. 33), that the taxpayer had 5,554 tons of the *same sort* of steel on hand December 31, 1921, as it did on December 31, 1916, the fact remains that, except for some portion not determinable and presumably small, the 1921 reserve steel *was not the same steel* as that of 1916.

Merchants and manufacturers generally maintain reserve stocks which are replenished regularly, and the fact that a similar quantity of raw materials is held throughout does not justify the conclusion that income is not derived from the use of such stock. The test for the tax collector, as the minority opinion suggests (R. 41), is whether there is a continued commingling in an indistinguishable mass and a productive use out of the mass in the business. If so, inventories are required to determine profit or loss. It does not constitute an exception to this rule that the finished stock is not held for any time nor that contracts are entered into prior to production. It is also immaterial what descriptive term be applied to the business, although we submit here that the fabrication of steel is essentially a manufacturing process.

Furthermore, the facts do not justify the conclusion that the reserve stock of the taxpayer was any

different in substance from the stocks of raw materials maintained by manufacturers who admittedly must inventory them. As is generally the case with such stock, that of the taxpayer was kept in good faith; its maintenance was made necessary by the remoteness of the more general supply; and its amount was as small as the demands of uninterrupted production would permit. It was an "emergency" stock only in the sense that it was used to supply the immediate and somewhat temporary needs of business. It was in a state of constant turnover; its amount fluctuated from approximately 1,500 tons to 11,000 tons (See Exhibit A, R. 18–19); and both new and old stock were so intermingled that specific items could not be identified either as to actual cost or date of acquisition.

In order to determine the taxpayer's true income for the years in question it was necessary to determine the cost of the steel which it actually used, as distinguished from that which it had ordered and would have used had not circumstances prevented. The part of the steel used which came direct from the mills could possibly be identified with specific invoices and its cost determined accordingly; but the steel withdrawn from stock could not be so identified and hence its cost could be determined only by resort to inventories. Such inventories, like all inventories, served merely as a lumping method of determining cost. By adding the inventory of the material on hand at the be-

95775—30——8

ginning of the year to the cost of the material purchased during the year, and then deducting from the total the inventory of the material remaining on hand at the close of the year, the cost of the material consumed could be determined. It is, in fact, the only way by which costs and income can be determined where there is a continued commingling of materials in an unidentifiable mass and production therefrom.

Regulations promulgated by the Treasury Department relative to the various Revenue Acts specifically provide for the use of inventories whenever such stocks are maintained for production purposes. Treasury Regulations 45, *supra*, states:

> ART. 1581. In order to reflect the net income correctly, inventories at the beginning and end of each year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include raw materials and supplies on hand that have been acquired for sale, consumption, or use in productive processes * * *.

Such regulations, if addressed to and reasonably adapted to the enforcement of an Act of Congress, have the force and effect of law when not in conflict with express statutory provisions. *Maryland Casualty Co.* v. *United States,* 251 U. S. 342, 349; *United States* v. *Grimaud,* 220 U. S. 506; *Bellefield* v. *Heiner* (C. C. A. 3d), 25 F. (2d) 560. The regulations of the Treasury Department relative to

inventories have been approved by both the Circuit Court of Appeals for the Fifth Circuit and the United States Court of Claims. *United States* v. *Kemp,* 12 F. (2d) 7, 9, certiorari denied, 273 U. S. 703; *Chicago Frog & Switch Co.* v. *United States,* unreported, decided by the Court of Claims June 3, 1929.

Inventories are now almost universally used by business concerns which maintain fluctuating stocks of raw material, and their use is regarded by accountants to be in accord with the best business practice. Foulke, The Federal Income Tax, Sec. 642 (quoted in the court's opinion in this case), says:

> Inventories are necessary in those cases where owing to the quantity of goods or commodities involved in the transaction it is not practicable to keep a separate account of each piece. An inventory is simply a lumping method of determining the gain or loss on the conversion of property in quantities where there is a fluctuation from year to year of the amount on hand, with a practical impossibility of separately itemizing the articles which are added or taken away.

Montgomery, Income Tax Procedure, 1926 Edition, Volume I, page 698, says:

> When a concern maintains a stock of any kind of property which is periodically renewed as it becomes exhausted, the proper procedure in determining profit or loss is to inventory the stock. * * *

Congress, in enacting the various Revenue Acts, recognized the necessity for inventories in the determination of income, but realized the difficulty of making any fixed rules as to when they should be used. It therefore placed a broad discretion in the Commissioner of Internal Revenue. The Revenue Act of 1918 (*supra*) provides:

> SEC. 203. That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

In this case the Commissioner determined that inventories were necessary to a clear determination of the taxpayer's income. The taxpayer had itself used inventories through all the years referred to in the record, and subsequently to December 31, 1921, when prices had become normal, inventoried all its stock at cost or market, whichever was lower, (R. 22.)

In consideration of the foregoing and in the absence of any evidence that the Commissioner abused the discretion vested in him by statute, it is submitted that the decision which he made in the exercise of that discretion should not be disturbed. *Williamsport Co.* v. *United States,* 277 U. S. 551; *Bates & Guild Co.* v. *Payne,* 194 U. S. 106, 108–110.

II

THE "BASE STOCK" METHOD OF INVENTORY VALUATION EMPLOYED BY THE TAXPAYER IS NOT IN ACCORD WITH THE BEST ACCOUNTING PRACTICE AND DOES NOT TRULY REFLECT INCOME

The majority opinion in the court below by the references (R. 34, 39) to the so-called "minimum" inventory system (which is more generally referred to as the "base stock" method) apparently concedes that such a method of valuing reserve stocks would not be sanctioned if adopted by merchants or manufacturers. It is the court's conclusion, however, that the taxpayer here does not fall within such a category and that its method of treating the reserve stock is not open to objection from an income tax standpoint.

It has previously been shown that the business of the taxpayer is essentially of a nature requiring recourse to inventories if income is clearly to be reflected and that the Commissioner had so determined. There remains for discussion whether or not the inventory method followed by the taxpayer with respect to its reserve stock was correctly changed by the Commissioner.

During the years of suddenly advancing steel prices the taxpayer treated its inventory as though divided in two parts: (1) the "minimum" or "base" inventory which it arbitrarily set at 5,554 tons and which it arbitrarily valued at $1.70 per cwt., and (2) the inventory in excess of 5,554 tons, which it valued at cost or market, whichever was

lower. The "minimum" inventory is regarded as a nonfluctuating, nonchanging unit. It ignored the fact that the specific items composing it were in fact gradually consumed on a high-priced market, and that the new steel, procured to keep up the stock, was actually obtained at a considerable increase in cost. It valued this "minimum" inventory as though the steel which originally composed it always remained in stock, and thus from year to year it set up on its books the constant valuation of $1.70 per cwt.

The system followed is known to accounting as the "base stock," "minimum," or "cushion" method, and will hereinafter be referred to as the "base stock" method. Such method of valuation is fundamentally unsound in that it does not truly reflect income. In years of rising prices it causes an understatement of income, for it disregards the gains actually realized through liquidation of low-priced stock on a high-priced market. In times of falling prices it causes an overstatement of income, for it ignores the losses which result when the high-priced stock is consumed. It substitutes an arbitrary bookkeeping figure for the true cost of the materials which compose the stock, sets up a false valuation for the stock account, and prevents a true reflection of the taxpayer's financial position in any balance sheet in which the valuations are used.

The "base stock" method also prevents the recognition of gains and losses in the proper taxable years. By ignoring the stock turnover it balances

the gains realized in one year against the losses sustained in another year and prohibits the recognition of any such gains or losses until the year in which the entire inventory is finally liquidated. This is at variance with the Federal income tax system, which is based upon an annual accounting period and requires that gains or losses be accounted for in the years when realized. This requirement was not met in the method followed by the taxpayer with respect to its reserve stock, and hence such method was properly disapproved by the Commissioner.

Moreover, the "base stock" method of inventory valuation is not in accord with the best accounting practice; it is not widely used by business organizations; and it is in conflict with regulations which the Treasury Department has applied for more than ten years in the collection of the revenue. Shortly after the enactment of the Revenue Act of 1918 the Advisory Tax Board, created by that Act for the special purpose of assisting in the interpretation and administration of the revenue laws, undertook an exhaustive study of the "base stock" method of inventory, and its conclusions were published by the Treasury Department in June, 1919, as Tax Board Ruling 65, 1 C. B. 51. (See appendix to this brief.) Excerpts from those conclusions are as follows (p. 52):

> The facts before the Advisory Tax Board do not warrant the conclusion that there has

been any general adoption of the base-stock method of taking inventories as an "accounting practice," or that it has had any considerable recognition as the "best" accounting practice. On the contrary, it is certain that the method has not been widely adopted. The argument from usage is against rather than in favor of it. To sanction this method of inventorying in the case of the very small minority of taxpayers who have used it—some like the appellant, only for the last year or two—would work an unjustifiable discrimination against the great majority of manufacturers and dealers who have not used it. * * * Probably more than 95 per cent of the manufacturers and dealers in this country—certainly a very large majority of them—keep their books in accordance with methods other than the base-stock method. Unequal and discriminative treatment of this kind is to be avoided whenever possible. The "best accounting practice" set up in section 203 as the guide or standard for the commissioner must be a practice which not only clearly reflects the income but which has been "regularly employed," presumably for a number of years, by a majority of the taxpayers involved. A procedure to become a "practice" must be widely used and must have withstood the changing tests of time. Practically none of these tests is met in the present appeal. In particular, the fact that so few business concerns use the base-stock method is strongly

suggestive of the truth that it does not truly reflect the income.

Following the publication of the Advisory Tax Board ruling, the Regulations of the Treasury Department were amended so as to expressly disapprove "using a constant price or nominal value for a so-called normal quantity of materials or goods in stock" (Article 1582, Regulations 45, *supra*); and a similar disapproval has been incorporated in the Regulations for all Revenue Acts since enacted (Article 1582, Regulations 62, relative to the Revenue Act of 1921; Article 1612, Regulations 65, relative to the Revenue Act of 1924; Article 1612, Regulations 69, relative to the Revenue Act of 1926; and Article 102, Regulations 74, relative to the Revenue Act of 1928). Montgomery, Income Tax Procedure, 1926 Edition, Vol. I, p. 712, in commenting upon the provision in the Regulations disapproving, among others, the "base stock" method, says:

> The foregoing regulation is an admirable exposition of good accounting practice. * * *
>
> The five methods which are specifically disapproved are in themselves technical departures from good accounting practice.

The courts, also, have refused to sanction the use of the "base stock" inventory. In *Chicago Frog & Switch Co.* v. *United States, supra,* the taxpayer found it necessary to maintain on hand at all times

a substantial amount of rails. It therefore attempted to carry its inventory at a so-called base or standard price, which was the price at the beginning of the year, and it was not asserted that this price was either cost or market for the rails. The Commissioner of Internal Revenue adjusted the inventory to market price and his action was approved by the Court of Claims.

In *American Can Co.* v. *United States,* and associated cases (C. C. A. 3d), 31 F. (2d) 730, now pending in this Court on writs of certiorari, the taxpayer valued its stock of tin plate by a "constant inventory" system, which was very similar to the system used by the taxpayer in this case. There the taxpayer attempted to write up its opening inventory to a figure in excess of actual cost; here the taxpayer attempted to write down both its opening and closing inventories to a figure less than the actual cost. In both cases an arbitrary "base" figure was used and the true cost of the stock consumed was not reflected. Since the taxpayers in the above cases conceded that the "constant inventory" did not truly reflect income, and the court agreed that it did not, the review on certiorari does not involve the question here.

The Circuit Court of Appeals for the Second Circuit had occasion to consider the "constant inventory" system of the same taxpayer in the case of *American Can Co.* v. *Bowers,* 35 F. (2d) 832, and also agreed that the method did not properly reflect income.

Finally, it should be noted that the taxpayer in this case did not consistently use the "base stock" method of valuation from year to year, but abandoned it after the price of steel had fallen below $1.70. (R. 22.) It should also be noted that the taxpayer has failed to prove that such method of valuation was in accord with the best accounting practice in its trade or business. The Commissioner, on the other hand, has determined that it was not, and that the method followed did not truly reflect income. His determinations are *prima facie* correct. *Wickwire* v. *Reinecke,* 275 U. S. 101; *Reinecke* v. *Spalding,* 280 U. S. 227; *Brown* v. *Commissioner* (C. C. A. 5th), 22 F. (2d) 797; *Bishoff* v. *Commissioner* (C. C. A. 3d), 27 F. (2d) 91; *Avery* v. *Commissioner of Internal Revenue* (C. C. A. 5th), 22 F. (2d) 6. The Commissioner's determinations were approved by the Board of Tax Appeals, and it is believed that upon the record presented they should not have been disturbed.

CONCLUSION

We submit that the Circuit Court of Appeals for the Eighth Circuit has approved in these cases a method of valuing raw materials used in productive processes which does not reflect true income, which is not in accordance with the "best accounting practice in the trade or business," and which is at variance with the Regulations of the Treasury Department. Furthermore, the decision is inconsistent,

in principle at least, with what authority exists as to the question.

It is respectfully submitted that the judgment below should be reversed.

CHARLES E. HUGHES, Jr.,
Solicitor General.
G. A. YOUNGQUIST,
Assistant Attorney General.
SEWALL KEY,
RANDOLPH C. SHAW,
Special Assistants to the Attorney General.
C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue,
ALLIN H. PIERCE,
Special Attorney,
Bureau of Internal Revenue,
Of Counsel.

FEBRUARY, 1930.

APPENDIX

ADVISORY TAX BOARD RULING No. 65

22–19–531.
T. B. R. 65.

Section 203, Article 1582: Valuation of inventories.

Revenue Acts of 1917 and 1918.—The base-stock method of taking inventories is not warranted by the law or the regulations.

The question is raised as to whether under the Revenue Act of 1917 and 1918 the so-called "base stock," "minimum," or "cushion," hereinafter referred to as "base stock," method of taking inventories may be used.

Section 203 of the Revenue Act of 1918 provides as follows:

> That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Article 1582 of Regulations 45 provides in part that:

> Inventories should be valued at (a) cost, or (b) cost or market, whichever is lower.

According to the base-stock method of taking inventories a manufacturer or dealer values at the same price year after year the minimum quantity of goods which he must have on hand at all times. If this method is accepted as sound, a second question arises as to the method of determining this price. In the present case the closing inventory for the year 1916 was adopted as the minimum basis for quantity and unit of price, though there was some modification in the following year for new lines of goods.

Clearly the base-stock method of taking inventories is not within the terms of the regulations—that is, it is not such a basis as the Commissioner, with the approval of the Secretary, has prescribed. It remains to consider, however, whether such a method should be so prescribed "as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

The facts before the Advisory Tax Board do not warrant the conclusion that there has been any general adoption of the base-stock method of taking inventories as an accounting practice," or that it has had any considerable recognition as the "best" accounting practice. On the contrary, it is certain that the method has not been widely adopted. The argument from usage is against rather than in favor of it. To sanction this method of inventorying in the case of the very small minority of taxpayers who have used it—some like the appellant, only for the last year or two—would work an unjustifiable discrimination against the great majority of the manufacturers and dealers who have not used it. Returns for 1918 must be made in accord-

ance with the method of accounting regularly employed in keeping the books of the taxpayer, provided this method clearly reflects the income (sec. 212 (b)). Probably more than 95 per cent of the manufacturers and dealers in this country—certainly a very large majority of them—keep their books in accordance with methods other than the base-stock method. Unequal and discriminative treatment of this kind is to be avoided whenever possible. The "best accounting practice" set up in section 203 as the guide or standard for the commissioner must be a practice which not only clearly reflects the income but which has been "regularly employed," presumably for a number of years, by a majority of the taxpayers involved. A procedure to become a " practice" must be widely used and must have withstood the changing tests of time. Practically none of these tests is met in the present appeal. In particular, the fact that so few business concerns use the base-stock method is strongly suggestive of the truth that it does not truly reflect the income.

That it is a truth appears as clearly upon analysis as upon an examination of trade practice. The present Federal income-tax system is based upon an annual accounting period. The object of an inventory is to assign to an annual accounting period its profits and losses. The effect of the base stock inventory method is to assign all profits and losses in respect of the minimum inventory to the year in which such inventory is liquidated. This result is accomplished through ignoring sales and exchanges of individual items of the inventory and treating the minimum inventory as a unit. Each sale or exchange of property for other property

having a market value is, however, in fact a realization of taxable profit or deductible loss in the year in which it occurs and a method of accounting which disregards such realization does not truly reflect income. Such profit is not, as suggested by counsel, unrealized appreciation. It is none the less taxable profit because immediately reinvested in inventory. (Moreover, such reinvestment is not an operating expense but, on the contrary, is an expenditure for working assets.) Similarly, loss so realized is none the less deductible loss even though the inventory is not reduced in quantity. In some cases highly conservative business concerns reckon *trading profits* by comparing current costs with current sales, disregarding basic inventory gains as quasi-capital gains; but even such concerns do not ordinarily disregard inventory losses. This makes it clear that the basic stock method is a mere counsel of conservatism, which ignores quasi-capital gains from motives of prudence.

We do not believe that profit from the sale of a basic or minimum inventory is ordinarily a capital gain, but whether it is or not such gains when arising in an annual accounting period by reason of transactions which, taken by themselves, constitute realizations of profit or loss can not be disregarded under American (as distinguished from British) income tax laws. To disregard them is to overstate or understate, as the case may be, profits for the annual accounting period. Where the base stock method is used it is true, as was stated in Advisory Tax Board Recommendation 48 with respect to the average cost inventory method that "in a business requiring goods to be carried for lengthy

periods * * * this overstatement of profits will occur whenever the current market is declining, while on an advancing market the profits on the actual sales of the year will be understated." The Advisory Tax Board, therefore, concludes that the base stock inventory method does not "most clearly" reflect income. For a more complete discussion of the subject of inventories see the Advisory Tax Board recommendation above referred to.

The fundamental theory underlying this method is unsound. While the taxpayer in question happened to adopt 1916 prices in introducing this method of inventorying, the usual practice and general object of the basic method is to get the base or constant stock at a figure below cost and hold it there. It arises not from a desire to measure capital and net income accurately, but to play safe, stabilize profits, and provide reserves against possible future losses. It is a result of essentially the same policy and theory which lead bankers to write down their buildings to a nominal figure and to accumulate hidden reserves. These practices have never been allowed by income-tax law and procedure in the case of banks. They can not be allowed in the case of manufacturers. Excessive conservatism in measuring or accounting for capital and income may be nearly as deleterious as the excessive optimism which in the past led some corporations to overstate profits. The latter leads to bankruptcy. The former leads to various evils and brings retributive penalties when occasion arises to measure capital (or "invested capital") for the purposes of rate making, profit, regulation, and the determination of excess-profits taxes.

The base stock inventory is suggested as a method of equalizing gains and losses over a period of abnormal price conditions. In substance it results in offsetting an inventory gain of one year against an inventory loss of another rather than in assigning to each year its true gain or loss. The fact that the revenue act of 1918 in its provisions with respect to inventory loss and net loss (sections 204, 214 (a) (12), 234 (a) (14), authorizes in some cases the carrying of a loss realized in one year into accounts of another year is some indication that Congress did not intend that the ordinary inventory provisions should be construed to authorize such a transfer. Furthermore, the argument that the application of the ordinary rules as to inventories results in hardship is met by the fact that Congress has authorized relief against hardship through the medium of these inventory and net loss provisions in cases which are within the terms thereof.

The general importance of this subject makes it worthy of note that a distinguished British commission—the Committee on Financial Risks Attaching to the Holding of Trading Stocks—after a thorough investigation and analysis of this subject, decided against the base-stock method of inventorying in its report submitted December 5, 1918. (Cd. 9224, 1919.) "Accountants," the committee found in Great Britain, "with a few exceptions, consider that these practices (the base-stock method of inventorying and the practice among bankers of writing down buildings, accumulating secret reserves, etc.) misrepresent the facts. In good times large profits are made. If it is desirable to make reserves against the future, part of the profits realized should be set aside as reserves and so de-

nominated. If goods have been bought for £50 and their market price has not fallen below £50 at the time of striking a balance, it is a misuse of language and a travesty of fact to write their value down to £20 out of profits made by selling something else. The correct procedure, it is maintained, is to place the difference of £30 to reserve." And again, referring to the fact that the British Board of Inland Revenue has felt compelled under court decisions to recognize the base-stock method in certain industries, the committee adds: "And it appears that in the absence of a statutory definition the Board of Inland Revenue has felt itself unable to contest the base-stock system of valuation where it has prevailed. As the practice is repugnant to the views which Government and the majority of this committee hold as to the correct system of accounting, * * * this concession has not been extended beyond the point of obligation."

The reasons above stated lead to the conclusion that the base-stock method does not conform to the requirements of the Revenue Act of 1918. This conclusion does not, of course, preclude a taxpayer who values his inventory at cost and who retains identifiable goods year after year from attaining the result with respect to the identifiable goods so retained which would be attained through the use of the base-stock inventory method.

The general conclusion that the base-stock method does not conform to the requirements of the Revenue Act of 1918 applies to "goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices." According to article 1582 of Regulations

45, such goods "will be deemed to be the goods most recently purchased." The warrant for this presumption or inference is that in the absence of evidence as to the actual fact in the specific case it is, as conceded by counsel for the taxpayer, more nearly true than any other. This presumption or inference is, therefore, not only warranted but required by the statute which in authorizing the Commissioner, with the approval of the Secretary, to prescribe a basis upon which inventories shall be taken requires him to prescribe such basis as "most clearly" reflects the income. Conversely, he can not properly prescribe that "goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices" will be deemed to be the goods included in the minimum inventory.

It is suggested in behalf of the taxpayer that if the base stock method is not approved, some alternative method should be prescribed other than the valuation of inventories as required by the present regulations at cost or market, whichever is lower. One method proposed is that inventories be valued on a moving average basis over a period of five years, more or less. According to this method one-fifth, for example, of the inventory would be deemed to be the goods most recently purchased, and the balance the goods on hand at the beginning of the year. Another method proposed is that the goods in the inventory be deemed to be the earliest rather than the latest purchases. These methods are open to the same objections as is the base stock method. Inventories valued according to these methods would not as clearly reflect the income as-

signable to an accounting period as do inventories valued according to the present regulations.

Most of the reasoning above set forth with respect to the Revenue Act of 1918 applies to the Revenue Act of 1917. The Advisory Tax Board finds nothing in the earlier statute to warrant the use thereunder of methods of valuing inventories which can not be used under the later statute.

The Advisory Tax Board is of opinion, therefore, that neither the base-stock method of taking inventories, nor the moving average method, nor a method based upon the presumption that goods in the inventory are the earliest purchases, is in conformity with the provisions of the Revenue Act of 1917 or of the Revenue Act of 1918, and recommends that no change be made in the present regulations with respect to the method of taking inventories.

U. S. GOVERNMENT PRINTING OFFICE: 1930